

JUL 25 1991

CC:INTL-9902-86
Br2:JKSams

Attorney, Office of District Counsel, Buffalo District NA:BUF
Attn: Randall Andreozzi

Chief, Branch 2, Office of Associate Chief Counsel
(International) CC:INTL:Br2

Character of Research and Development Income Under Subpart F

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYERS INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

In a telephone conversation with Jim Sams, an attorney in this office, you asked informally for a short memorandum describing your discussion relating to the character for purposes of subpart F of the Code of royalties from the licensing of certain property.

The facts were described in general terms as follows. A controlled foreign corporation, Corp A, is actively engaged in the conduct of research and development resulting in the issuance of a number of different patents. Corp A licenses to unrelated entities outside the United States approximately 1 percent of the patents it has received from its research and development activities. Corp A receives royalties from the unrelated corporations to which it licenses these patents. It is presumed that the remainder of the patents are retained for use by related parties that are members of a controlled group of corporations.

You have asked whether the royalties received by Corp A may be characterized as income described in section 954(c)(2)(A) of the Code and section 1.954-2T(b)(5) of the regulations, which exclude from foreign personal holding company income rents and royalties received from unrelated persons that are derived in the active conduct of a trade or business. Pursuant to section 1.954-2T(d)(1), royalties derived from licensing property that a controlled foreign corporation has developed, created or produced will be characterized as income derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A). However, the controlled foreign corporation must be regularly

008545

engaged in the development, creation or production of the property it licenses. See Example 1 of section 1.954-2T(d)(3).

In Example 1 of section 1.954-2T(d)(3) of the regulations, a controlled foreign corporation owns and operates a research facility through a full-time professional staff of scientists, engineers and technicians. The foreign corporation licenses or sells the patents it develops, but the example does not state whether or to what extent the sales were made to unrelated parties. Thus, it is implied that this factor is not material to the determination of whether a controlled foreign corporation qualifies for the active business exception of section 954(c)(2)(A) of the Code.

In this case Corp A is regularly engaged in the development and creation of patents, though only a portion of those patents are actually licensed to unrelated parties. The regulations require that a controlled foreign corporation be regularly engaged in the development, creation or production of the property that it licenses. It is not required that all of the property so produced be licensed to unrelated parties. Therefore, assuming the facts of this case otherwise parallel those of Example 1 of section 1.954-2T(d)(3) of the regulations, we believe that Corp A's royalties derived from licensing its patents to unrelated parties qualify for the active business exception of section 954(c)(2)(A) of the Code and the regulations thereunder. Our response may be different, of course, if Corp A does not itself develop, create or produce the patents it licenses to unrelated parties.

If you have any questions or comments, please call me or Jim Sams at FTS 566-6645.



Phyllis E. Marcus